INTERAGENCY POLICY STATEMENT: BANK OWNED LIFE INSURANCE

The following policy statement parallels the Office of the Comptroller of the Currency (OCC) Bulletin 2000-23, *Bank Purchases of Life Insurance*. OCC developed this guidance in coordination with the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision. Each agency agreed, in principle, to adopt similar guidance to that contained in Bulletin 2000-23. OTS's previous guidance is superceded by the following guidance.

BACKGROUND

Bank-owned life insurance (BOLI) includes all life insurance that a corporation, such as a savings association, purchases and owns or has a beneficial interest in. As with most financial instruments, BOLI can be complicated and is not without risk. Furthermore, BOLI transactions are unique and represent activities that differ greatly from the main business activity of most financial institutions. Some institutions have purchased BOLI without fully understanding the transaction and the associated risks. The second part of this appendix includes discussions of the most common uses of BOLI and the associated risks.

LEGAL AUTHORITY

While there is no specific statutory authority for the purchase of life insurance, the banking agencies consider it legally permissible if it is incidental to banking, that is, useful in connection with the conduct of the savings association's business. Life insurance might be useful for the following purposes:

- Key-person insurance.
- Life insurance on borrowers.
- Life insurance purchased in connection with employee compensation and benefit plans.
- Cash value life insurance taken as security for loans.

The authority to purchase life insurance is subject to supervisory considerations outlined in this appendix. State-chartered associations must also comply with any applicable state laws.

The purchase of cash value life insurance not incidental to banking is not permitted without OTS approval. OTS may approve other uses for bank-owned life insurance on a case-by-case basis. However, a purchase of life insurance must address a legitimate need of the institution for insurance. Life insurance may not be purchased to generate funds for the thrift's normal operating expenses, for speculation, or for the primary purpose of providing estate-planning benefits for thrift insiders unless it is part of a reasonable compensation package. In addition, the purchase of life insurance is subject to supervisory considerations, and life insurance holdings must be consistent with safe and sound banking practices.

Savings associations should complete a thorough analysis before purchasing material amounts of BOLI. The supervisory policy, set forth below, includes minimum standards for pre-purchase analyses applicable to such purchases by savings associations.

SUPERVISORY POLICY

The purchase of cash value life insurance is a long-term, illiquid, nonamortizing asset, and is an unsecured obligation of the insurance carrier. As such, it subjects the policyholder to credit, liquidity, and interest rate risks. Savings associations holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory action. These supervisory actions may include but are not limited to partial surrender or divestiture of affected policies.

Pre-Purchase Analysis

The safe and sound use of cash value life insurance by savings associations depends on effective senior management and board oversight. Regardless of the institution's financial capacity and risk profile, the board must understand the role institution-owned life insurance plays in the overall business strategies of the institution. The board's role in analyzing and overseeing cash value life insurance should be commensurate with the size, complexity, and risk inherent in the transaction. Although the board may delegate decision-making authority related to purchases of life insurance to management, the board remains responsible for ensuring that such purchases are consistent with safe and sound banking practices.

Institution management and the board of directors cannot rely solely on a third-party analysis of the benefits of BOLI, such as one that a vendor or carrier of the product may prepare. OTS considers this an inappropriate transfer of the fiduciary responsibilities of the board and management to an outsider with a vested interest in selling the insurance product. Institution management must thoroughly review any such third-party analysis and make its own determination as to whether the purchase of BOLI is appropriate for the savings association. Such a review should include a comparison of various products and investment alternatives, be well documented, and, prior to any purchase, approved by the board of directors.

The objective of the pre-purchase analysis is to help ensure that the savings association understands the risks, rewards, and unique characteristics of BOLI. At a minimum, the pre-purchase analysis should consider the following standards.

I. <u>Determination of the Need for Insurance</u>

The institution should determine the need for insurance by identifying the specific risk of loss or obligation against which it is insuring. The existence of a risk of loss or an obligation does not necessarily mean that a savings association can purchase or hold an interest in life insurance. For example, a savings association may not purchase life insurance on a borrower as a mechanism for recovering obligations that the savings association has charged off, or expects to charge off, for reasons other than the borrower's death. Also, a savings association should surrender or otherwise liquidate permanent life insurance acquired through debts previously contracted (DPC) within a short time, generally 90 days, of obtaining control of the policy.

Additionally, the purchase of insurance to indemnify a savings association against a specific risk does not relieve it from other responsibilities related to managing that risk. For example, a savings association may purchase life insurance to indemnify itself from the loss of a "key person." However, savings associations should not use "key-person" life insurance in place of, nor does it diminish the need for, adequate management or "key-person" succession planning.

The savings association's authority to hold life insurance on a key person lapses if the individual is no longer a key person for the association. Specifically, the key person's retirement, resignation, discharge, or a change in the person's responsibilities will cause the association to lose its insurable interest in a key person.

State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. Savings associations may protect themselves against the risk of loss from the death of a borrower. That protection may be provided through self-insurance in the form of debt cancellation contracts, or by the purchase of life insurance policies on borrowers. In some states, the lenders insurable interest may equal the borrower's obligation plus the cost of insurance and the time value money.

Holding cash value life insurance in amount in excess of the thrift's risk of loss may invalidate an insurance policy and may be an unsafe and unsound practice. Once a credit is repaid, otherwise satisfied in full, or charged off, the risk of loss has been eliminated. Therefore, savings associations may be required to surrender or otherwise dispose of life insurance on individual borrowers under these circumstances. For this reason, the economic consequence of terminating the insurance should be considered in selecting the type of insurance and the structure the policy.

There has been much debate over the legality of an institution holding life insurance on employees that are no longer employed, either because of termination or because of retirement. Certainly, it may be argued that an insurable interest no longer exists. Because state laws differ widely on the issue of insurable interest, savings associations should obtain competent legal advise relating to the amount, coverage, and duration of insurance.

II. Quantifying the Amount of Insurance Needed

The savings association should estimate the size of the obligation or the risk of loss and ensure that they do not purchase an excessive amount of insurance in relation to the estimate. For such estimates, savings associations may include the cost of insurance and the time value of money in determining the amount of insurance needed. The savings association should base the estimate of the amount of insurance needed on reasonable financial and actuarial assumptions. In situations where a savings association purchases life insurance on a group of employees or a homogenous group of borrowers, it can estimate the size of the obligation or the risk of loss for the group on an aggregate basis. The savings association can then compare the aggregate obligation or risk of loss to the aggregate amount of insurance purchased.

Purchasing or holding excessive permanent insurance may be an unsafe and unsound practice if it subjects the institution to unwarranted risks. Bank-owned life insurance subjects a savings association to several risks, which may be significant. The risks are explained in the "Risks Associated with BOLI" section of this bulletin.

III. Vendor Selection

The thrift does not have to use a vendor. In deciding whether or not to use a vendor or what type of vendor to use, the institution should consider the following items:

- The savings association's knowledge of BOLI.
- The resources the savings association can, and is willing to spend, servicing and administering the BOLI.
- The benefits a vendor may provide.

Depending on the vendor's role, the vendor's services can be extensive and critical to successful implementation and operation of a BOLI plan. If the institution uses a vendor, it should make appropriate inquiries to satisfy itself about the vendor's ability to honor its commitments, and its general reputation, experience, and financial capacity. The institution should base their review on the size and complexity of the potential BOLI purchase.

IV. Carrier Selection

BOLI plans are typically of long duration and may represent significant risks for the institution. Therefore, carrier selection is one of the most critical steps in a BOLI purchase. The institution should review the product design, pricing, and administrative services of the carrier(s) and compare them with the institution's needs. In addition, the institution should also review the carrier's ratings, general reputation, experience in the market place, and past performance. A broker or consultant, if used, may assist the institution in this regard.

Furthermore, before purchasing life insurance, the institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending.

V. Review the Characteristics of the Available Insurance Products

There are a few basic types of life insurance products in the marketplace. However, providers can combine and modify these products in many different ways. The resulting final product can be quite complex. The institution should review the characteristics of the various insurance products available. It should select the product or products with characteristics that match the institution's objectives and needs. To do this, the institution should thoroughly analyze and understand the products under consideration.

When purchasing insurance on "key persons" and individual borrowers, the institution should consider that the institution's need for the insurance will likely disappear before the insured individual dies. In such cases, term or declining term insurance is often the most appropriate form of life insurance.

VI. Analyze the Benefits of BOLI

The institution should analyze the benefits of BOLI purchases under consideration. The analysis should include an assessment of how the purchase will accomplish the objective specified in (I), Determination of the Need for Insurance. It should also include an analysis of the anticipated performance of the insurance, including the interest crediting rate and the policy's net accumulation rate.[1] While the projected yield on some single-premium life insurance policies may seem attractive, the actual yield may be much lower. Also, insurance and administrative costs the issuer builds into the policy further reduce such yields and life insurance becomes more expensive as the insured person ages. Often insurance costs will greatly reduce a high stated yield on a cash value product.

VII. Determine the Reasonableness of Compensation Provided to the Insured Employee if the Insurance Results in Additional Compensation

Split-dollar insurance arrangements typically provide additional compensation and/or other benefits to the employee. Before a savings association enters into a split-dollar arrangement, it should identify and quantify the compensation objective, and ensure that the arrangement is consistent with the stated objective. Also, the institution should combine the compensation provided by the split-dollar arrangement with all other compensation to ensure that total compensation is not excessive. OTS prohibits excessive compensation as an unsafe and unsound practice. There are guidelines for determining excessive compensation in Appendix A to 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness.

VIII. Analyze the Associated Risks and the Institution's Ability to Monitor and Respond to those Risks

Ownership of or beneficial interests in BOLI may subject a savings association to several risks. These risks include: transaction, credit, interest rate, liquidity, compliance, and price. A savings association's pre-purchase analysis should include a thorough evaluation of these risks. Furthermore, the pre-purchase analysis should allow a savings association to determine whether the transaction is consistent with safe and sound banking practices. In making this determination, a savings association should consider, among other things:

- The complexity of the transaction.
- The size of the transaction relative to the institution's capital.
- The diversification of the credit risk.
- The financial capacity of the institution.
- The financial capacity of the insurance carrier(s).
- The institution's ability to identify, measure, monitor, and control the associated risks.

In assessing the size of the transaction, a savings association should consider the cash surrender value (CSV)[2] relative to its capital levels at the time of purchase. The institution should also consider projected increases in the CSV and projected changes in capital levels for the duration of the contract.

Consistent with prudent risk management practices, a savings association should establish internal quantitative guidelines. These guidelines should generally limit the aggregate CSV of policies from any one insurance company and the aggregate CSV of policies from all insurance companies. A savings association must limit

[1] The interest-crediting rate refers to the gross yield on the investment in the insurance policy. That is the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs the issuer periodically charges against the policy's cash value. Insurance companies frequently disclose a current interest-crediting rate and a guaranteed minimum interest-crediting rate. The guaranteed rate may be less than the current rate. As a result, the potential exists for future declines in the interest-crediting rate. The net accumulation rate is the rate at which the policy increases after all costs are deducted, which may be materially less than the interest-crediting rate.

[2] The liquidation value of the insurance policy if the policyholder terminates it. In the first few policy years there may be a significant difference between the stated policy value and the cash surrender value due to early cancellation penalties.

investment in life insurance from any one issuer to the lending limits prescribed in 12 CFR § 560.93.

A savings association should also carefully evaluate its overall investment in life insurance to determine its own appropriate aggregate level. OTS generally considers a concentration to exist when a savings association invests more than 25 percent of its core capital in one industry or related group of companies or investments. Savings associations may not invest more than 25 percent of their total capital in bank-owned life insurance without first notifying and obtaining authorization from their OTS Regional Office. However, institutions should not automatically assume that a concentration level as high as 25 percent is acceptable, as any investment level must be justified and supported with proper underwriting, pre-purchase analysis, and board approval as discussed in this policy statement.

This limitation also applies to all BOLI, including separate account BOLI, even when the insurance carrier identifies such investments as separate accounts made up solely of high quality investments. This is because the control over the investment, and lack of liquidity associated with BOLI apply to both separate account and general account products.

LTOB Limits

For certain separate account BOLI, a savings association may look through to the underlying asset for determining applicability of OTS's loans-to-one borrower limitations of 12 CFR § 560.93.

To qualify for separate treatment of the investment under 12 CFR § 560.93, a thrift must evaluate the issuer's controls over its separate account assets (such as internal and external audits of the assets and activities of the separate accounts, segregation of duties for staff managing the accounts, and a review of fund reporting requirements) and determine that such controls are sufficient to prevent any accidental or illicit misuse of assets in the separate accounts. During their examinations, OTS examiners will review the thrift's documentation evidencing the legality and appropriateness of the underlying investments, and the institution's evaluation of the sufficiency of the insurance company's internal and external controls over the separate accounts. In the absence of a thorough review by the thrift demonstrating a reliable and bankruptcy remote separation of such accounts by a financially sound and well-managed issuer, the limitations of 12 CFR § 560.93 will apply.

The savings association should also obtain a legal opinion stating that such separate account assets are insulated by statute or otherwise from other unrelated liabilities of the insurance company.

IX. <u>Evaluate Alternatives</u>

Some BOLI purchases involve indemnifying the institution against a specific risk. For example, savings associations sometimes purchase BOLI to indemnify the institution against the potential for loss arising from the untimely death of a "key person." As an alternative to purchasing BOLI, an institution may choose to self-insure against this risk. Other uses for BOLI purchases are to recover costs or provide for employee benefits. In these cases, instead of purchasing BOLI, an institution may choose to invest the money in other assets. Regardless of the purpose of BOLI, a complete pre-purchase analysis will include an analysis of the alternatives.

X. <u>Document Decision</u>

A savings association should maintain documentation adequate to show that the institution made an informed decision. The institution should continue to monitor that decision based on the standards set forth in this Handbook Section.

FINANCIAL CONSIDERATIONS

Institution management should also understand and analyze how BOLI will affect the institution's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the institution's earnings, capital, cash flows, and liquidity. Management should also consider the impact on the institution's earnings and capital should the institution, for any reason, need to surrender the insurance (before maturity at the death of the insured). This might occur if the institution had a credit quality concern relating to the issuer, if the tax treatment changed, or if the institution had other needs or uses for the invested funds.

RISKS ASSOCIATED WITH BOLI

Examiners should assess risk relative to its effect on capital and earnings. The applicable risks associated with BOLI are: *Transaction, Credit, Interest Rate, Liquidity, Compliance, and Price.* An analysis of how each of these risks affects the decision to purchase and hold BOLI is set forth in the following paragraphs.

Transaction Risk

The degree of transaction risk associated with BOLI is a function of a thrift not fully understanding or properly implementing a transaction. In addition to following the other guidelines included in this bulletin, savings associations should take two additional steps to help reduce transaction risk. Thrift management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect product performance are the policy's interest-crediting rate, mortality cost,[3] and other expense charges. Typically, the most significant variable is the interest-crediting rate, followed by the mortality cost. Therefore, before purchasing BOLI, a thrift should analyze projected policy values (CSV and death benefits) from multiple illustrations provided by the carrier. Savings associations should consider using different interest-crediting rates and mortality costs assumptions for each illustration.

Thrift management should also understand and analyze how BOLI will affect the thrift's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the thrift's earnings, capital, and liquidity. Management should also consider the impact on the thrift's earnings and capital should the thrift, for any reason, surrender the insurance before maturity at the death of the insured.

Credit Risk

All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With term insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured. Credit risk is primarily a function of the insurance carrier's ability (financial condition) and willingness to pay death benefits as promised. Credit risk may be reduced by the support provided by state insurance guaranty associations or funds. A thrift's credit exposure through the ownership of term life insurance is not reflected on the thrift's balance sheet.

With permanent insurance, credit risk arises from the insurance carrier's obligation to pay death benefits upon death of the insured and from its obligation to return the CSV to the policyholder upon request. The risk is similar to that with term insurance, but there are a few differences. With most permanent insurance BOLI plans, the expected time for collection of death proceeds is extremely long. Additionally, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. The risk inherent in the insurance company's failure to return the CSV value is reflected on the thrift's balance sheet.

Before purchasing life insurance, thrift management should evaluate the financial condition of the insurance company and continue to monitor its condition on an ongoing basis. In addition to reviewing the insurance carrier's ratings, the thrift should conduct an independent financial analysis consistent with safe and sound banking practices for commercial lending. As with lending, the depth and frequency of the analysis should be a function of the relative size and complexity of the transaction.

Interest Rate Risk

General account[4] products expose the policyholder to interest rate risk. The interest rate risk of these

[3] Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.

[4] General account life insurance products include whole life insurance or annuities where the policyholder's cash value and any income is supported by the general assets and credit of the issuing insurance company.

products is primarily a function of the policy's interest-crediting rate. The insurance carrier establishes interest-crediting rates. Over the long term, interest-crediting rates are primarily a function of the carrier's investment portfolio performance. The policy's CSV grows at a slower rate with a declining interest-crediting rate. Since a thrift's investment in permanent insurance is recorded at the policy's CSV, the thrift's earnings decline as the policy's interest-crediting rate declines.

Due to the interest rate risk inherent in this product, it is particularly important that management fully understand the risk before purchasing the policy. Before purchasing permanent insurance, thrift management should:

- Review the policy's past performance over various business cycles.
- Analyze projected policy values (CSV and death benefits).
- Consider having the carrier use a different interest-crediting rate for each set of policy projections.

Variable or separate account[5] products may also expose the thrift to interest rate risk depending on the types of assets held in the separate account. For example, if the separate account assets consist solely of Treasury securities, the thrift is exposed to interest rate risk in the same way as holding Treasury securities directly in its investment portfolio. However, because the thrift does not control the separate account assets, it is more difficult for the thrift to control this risk. Therefore, before purchasing a separate account product, thrift management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the thrift. Also, the thrift should establish monitoring and reporting systems that will enable the thrift to monitor and respond to price fluctuations.

Liquidity Risk

Usually, life insurance policies are not marketable and are illiquid. A secondary market for life insurance does not exist. Although the CSV of policies can be accessed quickly, it typically involves substantial loss. To access the CSV, the thrift must withdraw from or borrow against the policy. This may subject the thrift to surrender charges, taxes on the gain, and a tax penalty. In addition, the policyholder generally does not receive any cash flow until the death benefit is paid. The lack of liquidity in the product is more significant given that savings associations normally purchase life insurance policies through a conversion of a liquid asset (cash or marketable securities).

Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure the thrift has the long-term financial flexibility to hold this asset in accordance with its expected use. The inability of a thrift to hold the life insurance until maturity (collection of death benefits) may compromise the success of the BOLI plan.

Compliance Risk

Failure to comply with applicable laws, rules, regulations, and prescribed practices (including this bulletin) could compromise the success of a BOLI program and result in significant losses for the thrift as a result of fines, penalties, or loss of tax benefits. Because tax benefits are critical to the success of most BOLI plans, management of a thrift should exercise caution to ensure that its plans comply with all applicable tax laws. In addition, thrift management should ensure compliance with other applicable legal and regulatory standards. Other common legal and regulatory considerations include compliance with state insurable interest laws, the Employee Retirement Income Security Act of 1974 (ERISA), sections 23A and 23B of the Federal Reserve Act, 12 CFR

[5] Variable or separate account life insurance products may take the form of universal life insurance or annuities where the policyholder's cash value and income is supported by assets held by the insurance company in assets that are segregated from the general assets of the carrier. The policyholder assumes all investment and price risk, and the insurer serves to manage the assets for the policyholder and administer the policy. Generally, assets in separate accounts can only be used for payment of insurance and administration costs related to the policy and policyholder benefits.

Part 215 (Regulation O), and Appendix A to 12 CFR Part 30 - Interagency Guidelines Establishing Standards for Safety and Soundness. Due to the significance of the compliance risk, a thrift may want to seek the advice of qualified counsel.

Price Risk

Typically, price risk is associated with separate account BOLI. The policyholder selects an asset or group of assets to invest in and assumes all price risk associated with the investments within the separate account. In general, neither the CSV nor the interest-crediting rate on separate account products is guaranteed by the carrier. The amount of price risk is dependent upon the type of assets held within the separate account. With separate account BOLI, a savings association may elect to invest in very high quality assets or low quality assets. A savings association may only invest in separate account BOLI investments that the thrift may invest in directly.

Because the thrift does not have direct control the separate account assets, it is more difficult for the thrift to control the price or other risks. Therefore, before purchasing a separate account life insurance product, thrift management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate for the thrift. Also, thrift management should establish monitoring and reporting systems that will enable them to monitor and respond to price fluctuations.

Savings associations may purchase separate account insurance products that hold equity securities only for the purpose of hedging their obligations under employee compensation and benefit plans.[6] This lessens the effect of price risk on the thrift's financial statements because changes in the amount of the thrift's liability will be hedged by changes in the value of the separate account assets. An example of such a relationship would be where the amount of the thrift's deferred compensation obligation is measured by the value of a stock market index, and the separate account contains a stock mutual fund that mirrors the performance of that index. If the insurance cannot be characterized as an effective hedging transaction, the presence of equity securities in a separate account is impermissible.

In addition to the general considerations discussed above, which are applicable to any separate account product, further analysis should be performed when purchasing a separate account product involving equity securities. At a minimum, thrifts should:

- Analyze the thrift liability being hedged (e.g., deferred compensation) and the equity securities to be held as a hedge in the separate account. Such an analysis usually documents the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.
- Determine a target hedge effectiveness ratio and establish a method for measuring hedge effectiveness. Establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.
- Establish a process for analyzing and reporting the effect of the hedge on the thrift's income statement and capital ratios. Such an analysis usually shows results both with and without the hedging transaction.

ACCOUNTING CONSIDERATIONS

Savings associations should follow generally accepted accounting principles (GAAP) for financial reporting and Thrift Financial Report purposes. Financial Accounting Standards Board (FASB) Technical Bulletin 85-4, Accounting for Financial Purchases of Life Insurance, discusses how to account for investments in life insurance. The guidance set forth in Technical Bulletin 85-4 is generally appropriate for all forms of BOLI.

The savings association should follow FASB Technical Bulletin No. 85-4 when accounting for

[6] An economic hedge exists when an institution offsets changes in the value of the liability or other risk exposure being hedged by counterbalancing changes in the value of the hedging instrument.

insurance policies where the association receives all the cash value benefits. Sometimes the association receives all the benefits, but separately agrees to provide those benefits to the employee as deferred compensation. In this case, the savings association should account for the cash surrender value in accordance with FASB Technical Bulletin No. 85-4. Also, they should record a deferred liability for the deferred compensation arrangements in accordance with Accounting Principles Board Opinion No. 12, as amended by SFAS No. 106.

Under employee benefit split-dollar policies, the association and the employee agree to share in the policy's cash surrender value and death benefits. In some circumstances, the savings association may not be accruing a separate liability for the employee benefit. In such instances, the association should record an asset for its investment in the policy equal to the lower of one of the following values:

- The policy's cash surrender value, determined in accordance with FASB Technical Bulletin No. 85-4.
- The present value of the future cash flow(s) the savings association expects to receive discounted at an appropriate interest rate in accordance with Accounting Principles Board Opinion No. 21.

The savings association should immediately record the amount exceeding the investment as an employee benefit expense. The savings association may also, where appropriate, record it in other assets as a deferred charge. The savings association must amortize the asset as an employee benefit expense in a systematic and rational manner over the time remaining until the employee's full eligibility date. The association should update its interest in the CSV at least quarterly.

OTHER CONSIDERATIONS

A savings association should evaluate the financial condition of the insurance company before purchasing a life insurance policy. The association should continue to monitor its condition while the policy is in force.

The association should consider the tax and economic consequences of surrendering a cash value insurance policy before its maturity should that become necessary. The savings association should also consider the effect of any significant holdings of cash value life insurance (considered a long-term investment) on its capital and liquidity.

In addition, savings associations should determine the applicability of, and ensure compliance with, 12 CFR §§ 563.41, 563.42, and 563.43. For example, split-dollar arrangements may be subject to 12 CFR § 563.41 when a savings association purchases an insurance policy and the beneficiary is its holding company or a management official of the holding company. You must consider this an unsecured extension of credit. This is because the association pays the holding company's portion of the premium and the holding company will not fully reimburse the savings association for its payment until some time in the future. Federal savings associations may not make unsecured loans to affiliates.

In other cases, the parent holding company may actually own the insurance policy and pay the entire premium. A subsidiary association may make annual loans to the holding company in an amount equal to the premiums paid or, equal to the annual increase in the cash surrender value of the policy, with the insurance policy serving as collateral for the loan. The holding company repays the loans upon either the termination of employment or death of the insured employee. These loans are subject to the quantitative restrictions of 12 CFR § 563.41, including the collateral requirements, 130 percent of the amount of the loan in this case. Therefore, the transactions must also comply with the provisions of 12 CFR § 563.42.

Because the holding company is the beneficiary of the insurance policy, it is a participant in a transaction between a savings association and a third party.

Moreover, certain insurance arrangements may be subject to Regulation O. In cases where the savings association purchases the insurance to provide a fringe benefit to an executive officer of the savings association and the association pays the cost of the policy, the officer should either:

- Reimburse the association for the amount of the premiums, or
- Report the economic value of the insurance benefit to IRS as additional taxable or deferred income.

If the officer is responsible to reimburse all or a portion of the value of the insurance benefit, the obligation represents a loan by the association to the executive officer and may be subject to Regulation O.

The savings association should ensure execution of the appropriate policy endorsements, assignments, and related agreements. The savings association should also ensure that the policy provides adequate safeguards and controls to protect its interest in the policy. Determine whether the association's share of any cash surrender value and death benefits was appropriately endorsed or assigned to the association.

Evaluate all significant holdings and future purchases of life insurance by savings associations in light of the above guidelines. Consider any formal or informal contracts with the executives for deferred compensation or other benefit payments linked to the insurance arrangements. Review related contracts with the insurance policies.